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An analysis of international corporate tax reform

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Research Paper: International Tax Reform

Introduction

This research paper will focus on the current discussion in Washington D.C. regarding the reform of international taxation by the U.S. government.

Background Information

Before I begin, it is important to have some background information about the international taxation system in the U.S. So first of all, why do we have international taxation in the first place? Some U.S. corporations operate both domestically and internationally. When the U.S. government collects income tax from these corporations, it is allowed to tax all pre-tax earnings from domestic operations. However, the U.S. government is not allowed to do the same with corporations' foreign subsidiary earnings. Instead, the government may only tax international earnings that are repatriated, or sent back, to the parent company in the U.S. This form of taxation is known as a deferral system due to the delay. When a foreign subsidiary does repatriate earnings, it is done so, in technical terms, in the form of a dividend. However, if a foreign subsidiary decides not to repatriate earnings, those earnings become known as undistributed foreign earnings.

Relevance

In recent years, multinational companies have been accumulating an ever-increasing amount of undistributed foreign earnings. Critics see this as a loophole to avoid U.S. taxation. Corporations view this as purely a smart business decision since it increases their bottom lines. The primary reason for this trend of not repatriating foreign earnings is that the U.S. has the highest corporate tax rate of 35 percent. Therefore, with fewer foreign earnings making their way back into the U.S., the government doesn't collect as much potential tax revenue as it could. As a result, the overall U.S. economy suffers.

There are three main audiences for this research paper:

1. The U.S. policy-makers currently debating the international tax reform options.
2. The U.S. corporations with international operations.
3. International tax planners.

Research Question

How will the repeal of the deferral system of international taxation financially affect the U.S. government in terms of tax revenue generated? The repeal of deferral means that the U.S. government will be able to tax all foreign income when it is earned rather than having to wait until those earnings are repatriated.

Existing Research

Regarding the direct financial impact of the repeal of the deferral system of international taxation, I didn't find any relevant existing research. Most of the existing research critiqued the proposed changes from a political viewpoint and then evaluated whether or not the changes would work. None of the research focused on the future dollars that could be generated by each proposal. However, I did base my research on one key assumption: the future corporate tax rate will be 25 percent. I felt comfortable using this assumption since one of the reform proposals I used in this research (see next paragraph) assumed this future rate and the general consensus within the tax community would also agree with this rate.

The most useful information I found were the specific proposed changes to the tax regulations, of which I found two probable plans. The first is from Max Baucus, Chairman of the Senate Committee on Finance, and the other from Dave Camp, Chairman of the Committee on Ways and Means. The specifics of these two proposals will be covered later within the research methodology section.

Research Methodology

In order to find the financial effects of the repeal of deferral, I needed to first quantify the number of dollars currently sitting abroad as undistributed foreign earnings. To do this, I decided to sample the Fortune 500 companies. First, I used Excel's random number generator to find a sample of 25 companies. I then went to the SEC's website in order to find each of the 25 companies' current year 10-K annual report. Once I pulled each annual report, I analyzed the footnotes of the financial statements for the income tax footnote. This footnote contained details about whether or not each company had any accumulated undistributed foreign earnings. Some reports included the prior year undistributed foreign earnings as well, but for those that did not, I simply found the prior year 10-K.

Once I had compiled two years of accumulated undistributed foreign earnings, I projected the current year accumulated number and the current year's increase to the entire Fortune 500 population. To do this, I first summed my sample's foreign undistributed earnings, and then multiplied this sum by 20 since my sample represented 1/20 of the total Fortune 500. However, I believed this projection was far too low since it was only about three times as high as Apple's foreign undistributed earnings alone. Therefore, I decided to revise my sampling technique in order to receive a more accurate projection.

For my revised sample, I decided to sample the top 25 Fortune 500 companies in order to capture those companies with the highest amount of undistributed foreign earnings. Then, with the remaining 475 companies, I once again used Excel's random number generator to select 25 of these companies. Again, as with my first sample, I collected undistributed foreign earnings data from each company's 10-K. This time, to project my sample to the entire population, I added the data from the top 25 companies plus 19 times the data from the 25 companies selected from the other 475 companies.

In order to make my sample projection meaningful, I used the guidelines set forth by both the Baucus and Camp proposals to manipulate my data and show the true financial impact of both proposals. Here are the details regarding the two different proposals:

- **Baucus[1]:**
  - 15% or 20% future tax on foreign earnings
  - 20% one-time tax on accumulated undistributed foreign earnings
  - Full inclusion of foreign credits and deductions
- **Camp[2]:**
  - 1.25% future tax on foreign earnings
  - 8.75% one-time tax on accumulated undistributed foreign earnings
  - Use of foreign credits and deductions not allowed

For the Baucus proposal, the 15 or 20 percent future tax rates (the two options currently undergoing discussion) are derived from 60 and 80 percent, respectively, of the future 25 percent corporate tax rate. For the Camp proposal, the 1.25 percent is derived from 5 percent of the future 25 percent tax rate since this proposal exempts 95 percent of foreign earnings. These three different rates (15, 20 and 1.25 percent) are those that would be implemented each year on all foreign earnings.

Before these future rates can be implemented, there must be a transitional tax to take care of the accumulated undistributed foreign earnings. This is represented with the 20 and 8.75 percent one-time tax rates, which is also known as a "tax holiday." Tax revenue generated on the one-time tax holiday would be payable over an eight year period.

Finally, you may notice that there is a significant gap between tax rates for the two different proposals. The reason for this discrepancy is due to the Baucus plan allowing credits and deductions while the Camp plan does not. Therefore, companies have the opportunity to reduce their tax liabilities under the Baucus plan.

Key Findings & Conclusion

Based on my excel computations and analysis, I found the Camp proposal to be the safer and more reliable option in terms of tax revenue generated from the repatriation of accumulated and current undistributed foreign earnings. However, the Baucus proposal is more beneficial to the government as the foreign tax rates of multinational companies increases. On the other side, my research suggests that the lower tax rate under the Baucus plan would be ineffective for companies in lower tax jurisdictions that are able to take advantage of tax benefits generated by operating internationally.

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[1] http://www.finance.senate.gov/imo/media/doc/Chairman's%20Staff%20International%20Discussion%20Draft%20Summary.pdf

[2] http://www.dlapiper.com/en/us/insights/publications/2014/02/camp-unveils-major-tax-reform-plan-today/

Limitations & Further Research

When conducting my research, I discovered a few limitations. First, I used a decently sized sample, but I could have easily doubled my sample size for more accurate results. For the best results, it would be ideal to sample the entire Fortune 500 population. Additionally, in my tax reconciliation, I assumed the same foreign tax rates for all the companies. Since this is highly unlike, it would be better to use each company's financials to estimate their individual foreign tax rates. Finally, the proposals are not yet final, so my predictions could easily change if the proposed rates change.

In regards to further research, I believe it would be interesting to try a few different approaches. These could include:

- Assuming different future U.S. corporate tax rates
- Analyze using company-by-company tax rates, as mentioned in the limitations section above
- The impact of allowing or disallowing tax credits and deductions
- Analyzing how a lower corporate tax rate affects the ability for domestic corporations to compete with multinational corporations.